



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	02/21/01	Bill No:	AB 593
Tax:	Sales and Use	Author:	Diaz
Board Position:		Related Bills:	

BILL SUMMARY

This bill would exempt from the 5 percent state sales and use tax, computer and computer peripheral equipment, as defined, purchased by new establishments engaged in software development for use in developing and manufacturing custom or prepackaged software, as specified.

ANALYSIS

Current Law

Under existing law, a sales tax is imposed on retailers for the privilege of selling tangible personal property in this state. The use tax is imposed on the storage, use, or other consumption in this state of tangible personal property purchased. Either the sales tax or the use tax applies with respect to all sales or purchases of tangible personal property, unless that property is specifically exempted.

Existing law, Section 6377 of the Sales and Use Tax Law, provides an exemption from the 5 percent state sales and use tax, for the sale and purchase of any tangible personal property purchased for use in a new manufacturing business, as defined, which is:

- (1) used by a qualified person, as defined, primarily in any stage of manufacturing, processing, refining, recycling or fabricating, or
- (2) primarily used in research and development by a qualified person, or
- (3) primarily used to maintain, repair, measure or test any property described in (1) or (2), or
- (4) sold to or purchased by a contractor for use in performance of a construction contract with a qualified person, as specified.

The Sales and Use Tax Law also currently provides some exemptions related to the computer industry. For example, Section 6010.9 provides an exemption for charges in connection with the sale of custom computer programs. In addition, the existing 5

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percent manufacturing exemption contained in Section 6377 applies to any computer and computer software used or required to operate, control, regulate, or maintain property used in manufacturing.

Proposed Law

This bill would amend Section 6377 of the Sales and Use Tax Law to:

1. Include within the 5 percent manufacturers' exemption, the sale or purchase of computers and computer peripheral equipment for use by a qualified person in those lines of business described in Standard Industrial Codes (SIC) 7371 (computer programming services), 7372 (prepackaged software) and 7373 (computer integrated systems design).
2. Define computers and computer peripheral equipment by cross-referencing Section 168(l)(2)(B) of the Internal Revenue Code that is tangible personal property as defined in Section 1245(a) of that code that is used primarily to develop or manufacture prepackaged software or custom software prepared to the special order of the purchaser who uses the program to produce and sell or license copies of the program as prepackaged software.
3. Become operative on the first day of the first calendar quarter commencing more than 90 days after the bill becomes law.

Background

Similar bills have been introduced in previous legislative sessions to expand the manufacturing exemption to the computer software industry:

AB 1063 (1997, Lempert, et al.), which was substantially similar to this measure and also had a corresponding income tax credit for existing software development establishments, was amended in the Senate Revenue and Taxation Committee to delete the sales and use tax provisions. This measure was later amended to delete the income tax provisions. The Board voted to support this measure.

AB 2661 (1996, Alpert), which was substantially similar to AB 1063 above, was held in the Senate Appropriations Committee.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by Governor Gray Davis in an attempt to extend the existing partial sales and use tax exemption for new manufacturers to new software developers, as these entities were inadvertently omitted from the bill that created the original manufacturers' partial sales and use tax exemption.

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2. **The proposed exemption would be more complicated to administer than other tax exemptions.** Like the current 5 percent exemption provided to qualifying manufacturers, this proposed 5 percent exemption for software developers would be more complicated to administer than most other exemptions. Generally, sales and use tax exemptions are targeted to a specific type of property, or purchaser, rather than a use to which that property would be put. The proposed exemption, like the current exemption, would have several criteria that must be considered before a purchase of computer equipment may be exempted from tax. The exemption would hinge on, the use of the equipment, the nature of the business, the “newness” of the business, whether the item is “consumable,” and more.

In addition, this bill, like the existing 5% exemption, would exempt only the state tax portion of the sales and use tax rate. Consequently, retailers making sales to qualifying purchasers are burdened with additional record keeping and segregations for purposes of reporting the correct amount of tax. For example, the retailer would be required to compute and collect the applicable local and district taxes on the sale, and then segregate these partially exempt sales from other sales in order to properly complete their sales and use tax returns. The Board’s experience with its administration of other partial exemptions indicates that errors on returns increase, which has a corresponding increase in the Board’s workload.

3. **How far should the current exemption for manufacturers be extended?** Since the original manufacturers’ exemption was created in 1993, there have been a variety of measures before the Legislature to broaden that exemption to other segments of industry, such as agricultural, biopharmaceutical, and teleproduction activities. Admittedly, there are numerous borderline activities between manufacturing and other divisions of the classification system. There are some manufacturing-type activities performed by establishments, such as manufacture of software, that are covered in other divisions under the current classification system and consequently, do not fall within the current language of the exemption. Should all these borderline industries be included?
3. **Should the sunset date be extended?** Section 6377 currently contains a sunset date of January 1, 2001 or the next January 1 thereafter if certain employment figures are not obtained. Since this section could be repealed by its own terms, consideration should be given to extending the sunset language (page 7, lines 24 through 31), at least for purposes of this proposed partial exemption.

COST ESTIMATE

Administrative costs would be incurred in preparing and mailing a notice to taxpayers, and personnel time attributable to approving claimed exemptions, manually reviewing exemptions claimed on returns, amending Board regulations, and answering inquiries. An estimate of these costs is pending.

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REVENUE ESTIMATE

Based on expenditure data compiled by the Bureau of the Census, estimated 2002 purchases of computers and peripheral equipment by all California software developers will be about \$456 million.

This bill applies to new businesses only. Although there are no data that identify the portion of the above amount attributable to new businesses, that portion is likely to be fairly small. (This would be consistent with the Board's experience with the sales tax exemption for new manufacturers enacted in 1993.) If one assumes that new businesses comprise only 1 to 5 percent of the total expenditures, then exempt purchases would be \$4.56 million to \$22.8 million annually.

Revenue Summary

The estimated annual loss on sales of \$4.56 million to \$22.8 million is as follows:

State loss (5%)*	\$228,000 - \$1,140,000
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* While the state tax rate is 4.75 percent for calendar year 2001, it is assumed the tax rate will return to 5.0 percent in 2002.

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